***United States Court of Appeals***
***for the Second Circuit***

# PETITION FOR REHEARING EN BANC

Signed

# 75-6131

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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P/S

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THE AETNA CASUALTY AND SURETY COMPANY,

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,

Defendant-Appellee

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ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF CONNECTICUT



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APPELLEE'S PETITION FOR REHEARING WITH SUGGESTION FOR REHEARING IN BANC

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To the Honorable William H. Timbers, Circuit Judge, the Judges of the United States Court of Appeals for the Second Circuit, and Honorables Lloyd F. MacMahon and Jon O. Newman, District Judges:

Pursuant to Rules 35 and 40 of the Federal Rules of Appellate Procedure, the United States of America, appellee herein, by and through its counsel, petitions for a rehearing in this case, and respectfully suggests that the rehearing be heard in banc.

The point of law that in the opinion of the United States the Court has misapprehended lies in its conclusion that the transaction, or series of transactions, whereby the taxpayer corporation was organized, took over the assets and business of The Aetna Casualty and Surety Company, with its stock then being distributed to the so-called "stapled trust" for the benefit of the shareholders of

Aetna Life Insurance Company, constituted a reorganization as defined by Section 368(a)(1)(F) of the Internal Revenue Code of 1954. By virtue of this conclusion, which was not advanced or considered in the brief or argument of either party herein, the Court held that the taxpayer corporation was entitled to carry back to a taxable year of its predecessor corporation its net operating losses incurred in taxable years subsequent to the transaction, or series of transactions, above referred to.

In addition to the fact the Court's decision, based upon an issue not presented to the Court, deprived the United States of an opportunity to be heard on that issue and would thus appear to justify rehearing, the factors leading to the suggestion of rehearing in banc are as follows:

a. The decision in this case conflicts with the decision of this Court in Berghash v. Commissioner, 361 F. 2d 357 (1966), affirming 43 T.C. 743 (1966). The decision herein is also inconsistent with this Court's decision in the factually closely parallel case of Bausch & Lomb Optical Co. v. Commissioner, 267 F. 2d 75 (1959), cert. denied, 361 U.S. 835 (1959).

b. The decision in this case conflicts with the decision of the United States Supreme Court in Helvering v. Southwest Corp., 315 U.S. 194 (1942).

c. The decision in this case is inconsistent with decisions of the Courts of Appeals of the Fifth, Sixth, and Ninth Circuits, and with a decision of the Court of Claims.

d. The decision in this case is of major importance in the whole field of corporate reorganizations in that it gives to the

"F" reorganization so broad a scope as to obliterate the statutory limitations upon other types of reorganizations.

e. There are specific statutory provisions, unnoticed by the Court (and since the issue was not briefed, necessarily not called to its attention) why the transaction in this case could not qualify as an "F" reorganization.

1. Prior to the transactions that are the focus of this controversy, Aetna Life Insurance Company ("Aetna Life") owned 4,312,535 (61.61 percent) of the outstanding 7,000,000 shares of the stock of The Aetna Casualty and Surety Company ("Old Aetna"). The remaining 2,687,465 shares (38.39 percent) were owned by 3,952 other shareholders. For a number of reasons, including its own income tax liability, Aetna Life wished to alter this situation. Having procured from the Internal Revenue Service a ruling (R. 40-46) that a proposed transaction, or series of transactions, would constitute a "C" reorganization (i.e., a reorganization as defined by Section 368(a)(1)(C) of the Internal Revenue Code) and would not impose income tax liability upon it, its shareholders, or the shareholders of Old Aetna, Aetna Life caused the transactions to be completed as described in the opinion of the Court (Slip op., pp. 6064-6069) and of the District Court. (R. 108-113.) These may be summarily described as the creation by Aetna Life of a wholly owned subsidiary ("New Aetna") to which it issued 13,300,000 of its own shares, the merger of Old Aetna into New Aetna, by virtue of which the shares of Old Aetna were cancelled and the 3,952 outside shareholders of Old Aetna received 5,106,187 shares of the stock of Aetna Life,

which amounted to 20.338 percent of the outstanding shares after Aetna Life retired the shares of its own stock it received as a result of the merger. Aetna Life then distributed to trustees for its stockholders all of the stock of New Aetna, "stapled" so that any person owning stock in Aetna Life would have a proportionate beneficial interest in the stock of New Aetna. (R. 48-51.)

The result of these transactions was that the outside stockholders of Old Aetna, who had had a 38.39 percent interest in Old Aetna and no interest in Aetna Life, had a 20.338 percent interest in Aetna Life and, during the brief period while Aetna Life held the stock of New Aetna, no direct interest in Old Aetna or its successor, New Aetna. Then, when Aetna Life distributed the stock of New Aetna to the stapled trust, the former 38.39 percent stockholders in Old Aetna had a 20.338 percent interest in New Aetna and a 20.338 percent interest in Aetna Life. And, of course, the stockholders in Aetna Life prior to the transactions, had a corresponding decrease in their interest in Aetna Life from 100 percent to 79.662 percent, and a change from their indirect 61.61 percent interest in Old Aetna to a direct 79.662 interest in New Aetna.

After the reorganization, New Aetna, the taxpayer herein, suffered losses that it seeks to carry back to years prior to the reorganization to apply against income of Old Aetna for those earlier years. In the District Court, among other arguments, taxpayer argued that the transaction was an "F" reorganization, defined by Section 368(a)(1)(F) as "a mere change in identity, form, or

place of organization, however effected," thereby seeking authority, otherwise denied by Section 381(b), for the carryback beyond the reorganization. The District Court rejected this argument (R. 127-142), and it was abandoned and not renewed by the taxpayer on its appeal to this Court. The Government, consequently, did not discuss the question on brief or argument in this Court. The Court's decision, nevertheless, was that the transaction was an "F" reorganization, and on that basis it held the carryback permissible, and ordered the judgment of the District Court reversed.

Within the limits of a petition for rehearing, it is hardly possible, and questionably appropriate, fully to develop the considerations bearing upon the scope of the "F" reorganization either generally or within the context of this case. It is therefore respectfully suggested that the Court might invite briefs on the issue. But within the confines of this petition, and in support of it, we can and do point out that this and other Courts considering an asserted "F" reorganization involving two or more corporations, have held, or explicitly stated as a limitation on their holdings, that an "F" reorganization can encompass two or more corporations only if there is identity of proprietary interests in the corporations involved prior to the reorganization, and no shift in proprietary interests as a result. Those limitations are, of course, consistent with "a mere change in identity, form, or place of organization, however effected." In this case, with 3,952 outside shareholders owning a 38.39 percent interest, there was clearly at the outset no identity of proprietary interests in

Old Aetna on the one hand, and in Aetna Life or its then wholly owned subsidiary, New Aetna, on the other. A shift from a 38.39 percent to a 20.338 percent interest in New Aetna and in Aetna Life, was by no means insubstantial. By the standards employed by this and other Courts, the transaction here involved was well outside the limits of the "F" reorganization.

2. This Court in *Commissioner* v. *Berghash*, 361 F. 2d 257 (1966), affirmed in a relatively brief opinion the decision of the Tax Court reported at 43 T.C. 743, remarking (361 F. 2d, p. 260): "We approve the approach adopted by the Tax Court in *Gallagher*, *supra*, and we feel it was appropriately applied by the Tax Court in this case." *Berghash* involved the transfer of the business assets of a wholly owned corporation to a new corporation in which the former sole owner and a former employee each held 50 percent interests. In rejecting the argument that this was an "F" reorganization, the Tax Court stated (43 T.C., p. 752) that "*if a change in stock ownership or a shift in proprietary interest occurs, the transaction will fail to qualify as an (F) reorganization.*" [Emphasis in original.] In so holding, the Tax Court invoked its prior decision in *Gallagher* v. *Commissioner*, 39 T.C. 144 (1962), which this Court specifically approved in its *Berghash* opinion. In *Gallagher*, in connection with the transfer of business assets from an old to a new corporation, shareholders holding a 38 percent proprietary interest (the same percentage that the outside shareholders had in Old Aetna) were eliminated, and the Tax Court held that the shift in proprietary interest could not be encompassed in an "F" reorganization. Indeed, in affirming *Berghash*

and approving Gallagher, this Court was but following its earlier opinion in Ahles Realty Corp. v. Commissioner, 71 F. 2d 259 (1934), cert. denied, 293 U.S. 611 (1934), with regard to the scope of the "F" reorganization. Neither is consistent with the decision in this case.

On facts strikingly parallel to the present case, this Court in Bausch & Lomb Optical Co. v. Commissioner, 267 F. 2d 75 (1959), cert. denied, 361 U.S. 835 (1959), held that no reorganization resulted. The parent corporation there owned 79 percent interest in a subsidiary, with outside stockholders owning 21 percent. The parent wished to unify the operations of the two corporations, and caused the assets of the subsidiary to be transferred to the parent, with the outside stockholders of the subsidiary receiving stock of the parent. The focus there was upon the "C" reorganization, but in holding that no reorganization occurred, the Court's decision is necessarily inconsistent with the decision in this case.

3. The Supreme Court in Helvering v. Southwest Corporation, 315 U.S. 194 (1942), a case involving a creditors' reorganization, rejected an argument that the transaction constituted what is now an "F" reorganization, holding (315 U.S., pp. 202-203): "And a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization' within the meaning of clause E." The Congress, aware of this definitive decision, re-enacted in the same words the definition of reorganization now found in Section 368(a)(1)(F) of the 1954 Code. The Supreme Court's decision therefore remains authoritative, and must be accepted until modified by the Congress

or by the Court. Cf. this Court's decision in Estate of Gilman v. Commissioner (No. 76-4056, decided December 30, 1976).

4. The decision herein is inconsistent with the decisions of three Courts of Appeals and of the Court of Claims.

The Commissioner of Internal Revenue for some time took the position that though a merger of an operating corporation into a shell corporation (a mechanism often employed to change the place of incorporation) would constitute an "F" reorganization, a merger of two or more operating corporations, even with complete identity of shareholders, would not. He was supported in this position by the unanimous reviewed decision of the Tax Court in Estate of Stauffer v. Commissioner, 48 T.C. 277 (1967) and by Associated Machine v. Commissioner, 48 T.C. 318 (1967). Three Courts of Appeals, including one that reversed the Tax Court decisions, and the Court of Claims have, however, held that if there was identity of shareholders at the outset and if no shift in proprietary interests took place as a result of the transaction, a merger of two or more operating corporations could constitute an "F" reorganization. In each case, the limitations were integral to decision. With these limitations, the Commissioner has accepted the decisions. See Rev. Rul. 75-561, 1975-2 Cum. Bull. 129.

The first of these decisions was Davant v. Commissioner, 366 F. 2d 874 (C.A. 5, 1966), cert. denied, 386 U.S. 1022 (1967), in which the Fifth Circuit acknowledged (366 F. 2d, pp. 883-884) that while a substantial shift in proprietary interest was outside the scope of the "F" reorganization, merger of corporations with identity of shareholders and no shift in interest was a change in form rather

than in substance. More recently, in Home Construction Corp. v. United States, 439 F. 2d 1165 (C.A. 5, 1971), the Fifth Circuit summarized its holding as follows (403 F. 2d, p. 619):

> In summary, we hold that Davant established criteria which adequately define when a reorganization qualifies as a mere change in form, identity, or place or incorporation. These include identity of shareholders and their proprietary interests, unimpaired continuity of the essential business enterprise and a new form which is the alter ego of the old. While the instant reorganization was more complex, it still meets all the criteria established by Davant. It therefore was an F reorganization. [Emphasis supplied.]

The Court then proceeded (439 F. 2d, pp. 1171-1172) to emphasize that the criteria established for an "F" reorganization were also limitations upon it. With these limitations, the Court pointed out, the "F" reorganization would not obliterate the statutory limitations upon the other forms of reorganization, a consequence that, as we point out below, is inherent in this Court's decision in the present case.

The Ninth Circuit in Estate of Stauffer v. Commissioner, 403 F. 2d 611 (1968) and Associated Machine v. Commissioner, 403 F. 2d 622 (1968) reversed the two Tax Court decisions above referred to, and reached the same conclusions as had the Fifth Circuit as to the scope of the "F" reorganization. In its Stauffer opinion, the Court was explicit in concluding that the "F" reorganization was one (403 F. 2d, p. 619) "wherein the identity of the proprietary interest remains intact." In its Associated Machine opinion, the Court referred (403 F. 2d, p. 624) to this Court's Berghash opinion as identifying "the salient trait of an "F" reorganization as being an identity of proprietary interest in the transferee and transferor corporations."

The Court of Claims in Movielab, Inc. v. United States, 494 F. 2d 693 (1974) extensively reviewed the earlier decisions, and adopted their conclusion. Indicating its awareness that the limitations on the "F" reorganization set forth in the opinions of the Fifth and Ninth Circuits were essential if their conclusions were to be viable, the Court pointed out (494 F. 2d, p. 698): "Needless to say, the definition articulated by the Fifth and Ninth Circuits does not expand the "F" reorganization concept in such a way as to overwhelm the other reorganization provisions."

The Court of Appeals for the Sixth Circuit in Performance Systems, Inc. v. United States, 501 F. 2d 1338 (1974) accepted the reasoning of the Court of Claims in its Movielab opinion, supra.

In this case, we start without an identity of proprietary interests. Shareholders in Old Aetna other than Aetna Life held a 38.39 percent interest. As a result of the reorganization, there was a shift of that interest so that they acquired a 20.338 percent interest in Aetna Life, and their interest in New Aetna was reduced to 20.338 percent. The interests of Aetna Life and its shareholders were correspondingly altered. Such differences in proprietary interest at the outset and such shifts in proprietary interest in the course of the transaction are characteristic of other forms of reorganization, notably the "A" , the "B", and the "C". They are not characteristic of the "F" reorganization, which, by its terms, is limited to "a mere change in identity, form, or place of organization."

5. The Court's decision in this case would render meaningless the statutory limitations upon the other forms of reorganization.

Section 368 imposes upon most of the forms of reorganization therein defined a number of specific limitations. Among others, the "B" and "C" reorganizations are limited to exchanges for voting stock, with some limited measure of flexibility in the latter. The "D" reorganization, which requires some degree of linkage, but not identity, of proprietary interest in transferor and transferee corporations, is hedged further with detailed limitations that are set forth not only in Section 368(a)(1)(D), but also in Sections 354(b) and 355. All of these forms of reorganization encompass transactions in which there is divergence of proprietary interests at the outset and some shift by virtue of the reorganization.

The "F" reorganization, as befits the purely formal changes spelled out in Section 368(a)(1)(F), is not hedged with such specific limitations. But if it encompasses, as the Court has held herein, transactions in which there is divergence of interests at the outset, and shifts in interests as a result of the transaction, the specific limitations on the other forms will be stripped of the functions that they serve, and the undefined "F" will leave the reorganization concept substantially at large.

The Fifth Circuit and the Court of Claims, as we have pointed out, have explicitly shown themselves aware of this hazard. For that reason, they have been careful to insist that the limitations of identity of proprietary interest at the outset, and unbroken continuity of proprietary interest through the transaction, were integral to the "F" reorganization to prevent the obliteration or overwhelming of other forms of reorganization defined by the

statute. This Court's decision herein makes that hazard of obliteration or overwhelming very real.

6. There is a perhaps technical but nonetheless very specific statutory requirement that disqualifies the transaction in this case as an "F" reorganization. It was presumably unnoticed by the Court, and, since the "F" issue was not briefed, there was no opportunity to call it to the Court's attention.

It will be recalled that when Old Aetna was merged into New Aetna, the shareholders of Old Aetna received not shares of New Aetna, but shares of New Aetna's parent, Aetna Life. The Supreme Court held many years ago that the stock of a parent of the transferee corporation could not qualify as stock of a "party to the reorganization", now defined by Section 368(b), because it did not provide the continuity of interest required for a reorganization. Groman v. Commissioner, 302 U.S. 82 (1937); Helvering v. Bashford, 302 U.S. 454 (1938).

Those Supreme Court decisions remain completely authoritative, except as modified by statute. When the 1954 Code was adopted, the definition of the "C" reorganization was modified to include an exchange for "voting stock of a corporation which is in control of the acquiring corporation," and the definition of "party to a reorganization" in Section 368(b) was correspondingly broadened with respect to the "C" reorganization. Since then, similar amendments to the definitions of the "A" and "B" reorganizations have been made, with required broadening of Section 368(b) in reference to those forms of reorganization. But no such modification has been made with respect to the "D" reorganization (see Breech v.

United States, 439 F. 2d 409 (C.A. 9, 1971)) or with respect to the "F".

For this reason alone, and in addition to others stated above, the transactions in this case, though they could qualify as a "C" reorganization, as the Internal Revenue Service ruled, could not qualify as an "F".

7. Length limitations do not permit a complete analysis of the Court's opinion herein. It suffices for the present to point out that it appears central to the opinion that the Court treated the outside stockholders' interest in Old Aetna as having been redeemed (Slip op., pp. 6078, 6079, 6080) and that in that connection it invoked the decision of the Fifth Circuit in Reef Corp. v. Commissioner, 368 F. 2d 125 (1966), cert. denied, 386 U.S. 1018 (1967), where the Court treated a redemption as functionally unrelated to the reorganization. But in this case there was no redemption; a redemption would have been a taxable transaction to the stockholders of Old Aetna, and would probably have resulted in a tax on Aetna Life as well. Cf. Bausch & Lomb Optical Co. v. Commissioner, supra. With substantially altered interests, the stockholders of Old Aetna continued as stockholders of Aetna Life and New Aetna. The transaction that did take place was not functionally unrelated to the reorganization and related transactions, but integral to them. If Reef were applicable to a case such as this, it would be inconsistent with the same Court's and the same panel's contemporaneous decision in Davant, supra, and with the Fifth Circuit's later decision in in Home Construction, supra.

CONCLUSION

For the reasons stated above, this petition for rehearing should be granted.

Respectfully submitted,
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JANUARY, 1977.

## CERTIFICATE OF COUNSEL

The undersigned counsel for the United States hereby certifies that the foregoing petition for rehearing with suggestion for rehearing in banc is presented in good faith and not for the purpose of delay.

Myron C. Baum

MYRON C. BAUM,
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## CERTIFICATE OF SERVICE

It is hereby certified that service of this petition for rehearing with suggestion for rehearing in banc has been made upon opposing counsel by mailing four copies thereof, on this 27th day of January, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

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